



Our Research Methodology

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Introduction

Davis Advisors is an independent money management firm that was founded in 1969 by Shelby M.C. Davis. Mr. Davis represents the second generation of successful portfolio managers in the Davis family, whose multi-billion-dollar fortune was created through investing for over 60 years and three generations. We are specialists in equities and manage money on behalf of both individual and institutional investors.

The signature Davis investment discipline that we follow today traces its roots to Shelby's father, Shelby Cullom Davis, who was the Commissioner of Insurance in the state of New York in the 1940s. As the insurance regulator, Shelby Cullom Davis anticipated the demutualization of the insurance industry and decided to invest in that multi-decade trend. Starting with \$100,000 in 1947, he invested his family's capital primarily in financial stocks and proceeded to compound it into over \$800 million by the time of his death in 1994.¹ His discipline was straightforward: He purchased durable, well-managed businesses at value prices and held them for the long term, allowing the power of compounding to work.

Shelby M.C. Davis, our Founder, had been steeped in his father's investment discipline when he began his investment career on Wall Street in the early 1960s. He started as an analyst at The Bank of New York and eventually became Head of Research and was named the youngest Vice President at the Bank since Alexander Hamilton. In 1969, he founded Davis Advisors.

For more than a decade our two lead Portfolio Managers, Christopher C. Davis and Kenneth C. Feinberg, who possess vast experience in a wide range of industries and worked side by side with Shelby Davis, have managed our clients' Large Cap equity accounts with a team of analysts. Our investment management team today follows the same tradition of investment begun by the Davis family over 60 years ago.

As of December 31, 2009, the Davis family, Davis Advisors, employees, and directors have more than \$2 billion of their own money invested side by side with clients in the various mutual funds our firm manages.

The Davis Investment Discipline

As Shelby Cullom Davis articulated more than 60 years ago, our investment discipline consists of seeking durable, well-managed businesses at value prices and holding them for the long term. Our initial premise when investing in equities is that stocks are not pieces of paper like lottery tickets or speculative instruments, but ownership interests in real businesses. From that principle, our entire investment process separates into two basic questions: "What kind of businesses do we want to own over the long term?" and "How much should we pay for those businesses?"

Finding the Right Business

Taking those questions in order, the first is the research question: "What kind of businesses do we want to own?" Ultimately, what we try to define is: What businesses possess characteristics that foster the creation of value over long periods of time?

We evaluate prospective investments according to a list of criteria that, in our minds, describe high-quality businesses. These can be grouped into three categories: financial strength, competitive advantages and management evaluation. Our research begins with the financial category.

Financial Strength

Financial strength—beginning with the balance sheet—is very important to the survival and the earnings power of a business. Because we hold investments for a long period of time, we must feel confident that the companies we buy can withstand an industry and/or economic downturn. During our considerable holding period, either may occur, and a strong balance sheet allows some companies to survive, and even expand, when others cannot.

¹While Shelby Cullom Davis' success forms the basis of the Davis investment discipline, this was an extraordinary achievement and other investors may not enjoy the same success.

The second piece of financial data that we study is the return on capital. A company's return on capital is a key determinant of its ability to create value through reinvestment, which in turn is a key component of a company's "intrinsic value." The importance of return on capital can be understood as somewhat analogous to the reinvestment rate for a bond: Bondholders know that the longer they hold a bond, the more important the reinvestment rate becomes as a component of their total return. Similarly, in the case of a business, the reinvestment rate of cash flows will play a significant role in determining the business's earnings growth rate and intrinsic value, and by extension an investor's return on that business. We want to invest in companies that can generate a return on capital above their cost of capital.

To calculate return on capital, we use excess cash earnings, or what we refer to as "owner earnings." (Please refer to "How to Value a Business" on page 3 for a formal definition of owner earnings.) All other things being equal, a company that generates excess cash has more flexibility to effect changes in its value than companies that do not. For instance, with excess cash, management can buy back shares, make acquisitions or reinvest internally for growth, without relying necessarily on external funding. We use owner earnings rather than reported earnings because we feel our cash-based metric is a better descriptor of a company's true profitability. Reported earnings, by contrast, can be all too easily manipulated as a result of flexibility that Generally Accepted Accounting Principles (GAAP) allow in terms of discretionary accounting policies.

Finally, our financial analysis would not be complete without comparing individual companies against peers on the basis of revenues, margins, capital structure, and other factors.

Competitive Advantages

The next category of business characteristics that we study closely is competitive advantages, or what Warren Buffett has referred to as the "moats" around a business. In other words, does the company have brand? Does it have scale? Does it have distribution?

Does the company have a cost structure advantage? Does it have intellectual property? At the heart of these questions is the desire to know what allows one company to generate a superior return on capital compared to its competitors and how sustainable that advantage is.

Comparing charge card and credit card businesses makes an interesting case study. One well-known charge card provider, known also for its travel-related services, has what we consider a formidable brand. By virtue of that brand, this company is able to attract higher-spending, more affluent customers, which in turn allows it to charge merchants a higher "discount fee"—a percentage of the total dollars spent on its cards—than competitors.

The world of retailing offers another good example of competitive advantages. Certain large retailers have developed extremely lean, high turnover business models which can compete on price with virtually any other merchandiser. The scale, lean expense structure and high turnover of these large retailers allow them to offer merchandise at discount prices, a service deemed so valuable by consumers that many people are willing to pay a membership fee just to have access to those significant discounts. By transforming retail into membership-based purchasing networks, these discount retailers have succeeded in minimizing "leakage" from shoplifting—since members are by definition people who are willing to pay—while creating another source of very high-margin revenue (the membership fee) that other competitors do not have.

Brand, scale and lean expense structure are but a few examples of competitive advantages. In addition to identifying such advantages, we also try to assess whether they are growing or shrinking.

Management Evaluation

The third and final part of our analysis has to do with the quality of management. A highly successful business today is not assured a highly successful future. Outside of external factors, what determines whether a business grows in value in the future will be the

decisions of management. Not all investment advisors take the time to meet with company management. To us, however, meeting directly with management is essential, especially since we have so much of our own capital at stake. We try to address several important issues when evaluating managers:

First, we determine whether they have a history of allocating capital effectively on behalf of shareholders. We want to understand the thought process behind capital allocation decisions such as when and where to open/close facilities, how much to devote to research and development, whether non-performing assets should be improved or divested, and under what circumstances acquisitions make sense. We also want to establish that management has a firm understanding of their company's cost of capital and the expected return they might achieve on spending. Next, managers should have a strategic vision and a realistic plan to achieve that vision. Finally, we like to see that the management's interests are aligned with those of the shareholders. We look for owner-operators who deal honestly with shareholders.

Evaluating management is an iterative process that requires a great deal of time and patience. We typically study companies not for a matter of days or weeks, but over quarters and years. We build our conviction to invest in companies by studying management's actions over time and through different operating environments. We also monitor whether managers do what they say they will do and whether they report their results in a consistent fashion, both of which serve to establish some basic level of credibility. Finally, we interview competitors, vendors, suppliers, customers, and employees to complete our due diligence.

How to Value a Business

After determining which businesses are attractive on the basis of quality, we must also develop an estimate of their worth, since our purchase price—and more specifically, any discount or premium paid relative to intrinsic value—will be an important component of our investment return.

In our valuation methodology, we depart somewhat from Wall Street by dispensing with the accounting shorthand that other managers tend to favor, such as the price to earnings (P/E) multiple. There are fundamental problems with the P/E. First, the "P" only represents the per-share equity of a business, but excludes any debt the business might require to produce its earnings. It also ignores important adjustments that a sophisticated investor should make to determine an appropriate price for a company, such as marking to market certain balance sheet items carried at cost or taking into account off-balance sheet liabilities.

The "E" in the P/E multiple, which represents the per-share net income of a company, also poses problems. Above all, it is subject to manipulation through discretionary accounting choices such as extending depreciation schedules, changing pension assumptions, realizing gains on asset sales, and capitalizing items that more conservative managers would expense. We know that corporate managers are strongly incented to adopt whichever accounting policies will maximize their company's current results. Consequently, if we wish to understand the true earnings power of a business, we must adjust reported earnings so as to arrive at a cash-based, not an accounting-based, measure of earnings.

We calculate a business's worth using a methodology known as the "owner earnings yield." This is defined as owner earnings—or excess cash earnings—divided by enterprise value. To arrive at owner earnings, we begin with pre-tax operating income, remove non-operating sources of income (e.g., gain on sale of assets and amortized pension gains), adjust for the difference between depreciation and true maintenance spending, and charge the income statement for options granted, inflated pension assumptions, etc. We divide owner earnings by the company's enterprise value, which is the total amount that an investor would have to pay to own a business "free and clear." This means purchasing not only the entire market value of a company's equity, but also satisfying all debt obligations (including under-funded pension and health care liabilities). This calculation results in

an initial owner earnings yield, which represents our hypothetical first year's return on investment based on the current earnings of the business and the price we would have paid to own the entire company.

By valuing each prospective business on a yield, or "bond equivalent," basis we are able to compare the relative attractiveness of each investment against the risk-free rate, which is always the alternative for investors. A compelling value investment in our view is a business that can be purchased at a higher owner earnings yield than the prevailing risk-free rate and which possesses characteristics that foster the creation of value over the long term such as competitive advantages, high returns on capital and skilled management. Our ideal investment in a business is analogous to a hypothetical bond that offers an attractive current yield followed by a *growing*, not a fixed, stream of coupons into the future.

Our valuation discipline is ultimately what defines our investment strategy as a "value" approach by limiting our portfolio of investments to reasonable valuations. To illustrate how this works in practice, consider a company that trades at 40x earnings in a 5% risk-free environment—a frequent occurrence during the bull market of the late 1990s. Purchasing that company would yield 2.5% initially, and earnings would have to double just to achieve the risk-free rate. In our view, that situation would not allow a sufficient "margin of safety" to account for the possibility that the earnings growth assumed in the investment might not materialize. In our investment discipline, we think first about how much we could lose on an investment before considering how much we might gain. Consequently, we prefer to purchase shares of durable businesses that are selling at owner earnings yields *above* the risk-free rate—that is, with a margin of safety—with the possibility of future value creation.

Sell Discipline and Risk Management

While we set out with the intention of owning businesses over long horizons, we nonetheless are faced with sell decisions occasionally. We expect the

average turnover of our portfolio to be about 15–25% annually.² Our sell discipline centers around the same set of criteria as our buy discipline, which is to say that we evaluate businesses on the basis of their financial strength, competitive advantages and management quality, and we compare the intrinsic value of each company in our client accounts to the current market price. We sell investments, either partially or in their entirety, on the basis of valuation, deteriorating fundamentals and misinformation.

Our sell discipline is an important example of how we attempt to manage risk in our portfolios, but it is not the only example. We also attempt to reduce the risk of experiencing what legendary investor Benjamin Graham called a "permanent loss of capital" in our buy discipline as well; first, by purchasing what we believe are durable businesses and, second, by attempting to purchase shares of those businesses at a discount (i.e., with some "margin of safety"). Finally, we believe in the wisdom of diversifying across holdings. Our diversified portfolios hold a prudent number of securities at any given time, and we manage security weightings according to our view of each company's valuation and business risk.

Narrowing Down the Universe

There are literally thousands of stocks from which to choose as an investor. Yet, there are relatively few that even begin to meet our investment criteria. First, as mentioned above, we search for companies that have competitive advantages and who are leaders in their markets. This is usually a trait of large companies, and the universe of companies in the S&P 500® Index possessing a market cap of over \$10 billion is surprisingly limited. (There are 226.) Second, we want to find businesses that will grow over long periods of time in a sustainable fashion, and one of the best ways to identify such businesses is to identify long-term trends that will benefit certain industries disproportionately. For instance, we believe that demographics will have an enormous impact on the long-term demand for financial products and services, as well as pharmaceuticals. Not all financial and pharmaceutical companies will benefit, and in

²Over the last five fiscal years the turnover ratio of Clipper Fund has ranged from a low of 7% to a high of 63%.

fact it is likely that the spoils will go to a relative few, but spotting the trend and its potential impact on an area of the economy is a logical starting point for individual company research. We try to focus our research efforts on areas of opportunity and spend relatively little time on areas of the economy whose growth will be challenged.

Distinguishing Davis Advisors

Our patient, time-tested investment approach makes us unique as a money management organization in our industry, but there are other ways in which we distinguish ourselves from our industry peers as well.

Since our firm's inception in 1969, we have practiced the same patient investment discipline of seeking durable, well-managed businesses that can be purchased at value prices and held for the long term. It is the same investment discipline that has guided the Davis family for over 60 years and three generations. Very few organizations on Wall Street have experienced such continuity with respect to people, philosophy and process.

We take our fiduciary role as "stewards of capital" seriously and treat our accounts with great seriousness and care. The Davis family, Davis Advisors, employees, and directors have more than \$2 billion invested side by side with clients in the various mutual funds our firm manages, demonstrating our strong commitment to existing and new investors alike. We take the same risks and reap the same rewards as our clients, and we always consider how much money we could potentially lose on an investment before considering its potential return.

Finally, our investment discipline has proven successful for decades and through vastly different economic environments.³ We have applied it successfully in times of higher interest rates, lower interest rates, inflation, deflation, industry crises, and war. Today, we are one of the only management firms in existence whose Large Cap Value Composite (net of fees) has outperformed the S&P 500® Index in every rolling 10 year period since our inception more than 40 years ago.⁴ This long-term track record gives us conviction that our strategy over full market cycles is well suited to weather market and economic conditions the future may bring. ■

The performance presented represents past performance and is not a guarantee of future results. Total return assumes reinvestment of dividends and capital gain distributions. Investment return and principal value will vary so that, when redeemed, an investor's shares may be worth more or less than their original cost. The average annual total returns for Clipper Fund for periods ending December 31, 2009, were: 1 year, 37.60%; 5 years, -4.40%; and 10 years, 3.74%. The total annual operating expense ratio for Clipper Fund shares as of the most recent prospectus was 0.76%. The total annual operating expense ratio may vary in future years. Current performance may be higher or lower than the performance data quoted. For most recent month-end returns, visit clipperfund.com or call 800-432-2504. The Fund received favorable class action settlements from companies that it no longer owns. These settlements had a material impact on the investment performance of the Fund in 2009. This was a one-time event that is unlikely to be repeated. Clipper Fund was managed from inception, February 29, 1984, until January 1, 2006 by another Advisor. Davis Selected Advisers, L.P. took over management of the Fund on January 1, 2006.

³Equity markets are volatile and there is no guarantee that Davis will continue to deliver attractive results. **Past performance is not a guarantee of future results.** ⁴Based on Davis Advisors' Large Cap Value Composite, net of fees. Rolling 10 year returns are from the first full calendar year after inception of the Composite (January 1, 1970). See endnotes for a description of our rolling 10 year performance and a definition of the S&P 500® Index. **Past performance is not a guarantee of future results.**



This material is authorized for use by existing shareholders. A current Clipper Fund prospectus must accompany or precede this piece if it is distributed to prospective shareholders. You should carefully consider the Fund's investment objectives, risks, fees, and expenses before investing. Read the prospectus carefully before you invest or send money.

The Clipper Fund is not a part of Davis Advisors' Large Cap Value Composite and the returns for the Clipper Fund will vary from Davis Advisors' Large Cap Value Composite's returns.

Davis Advisors is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy and approach. Our views and opinions regarding the investment prospects of the portfolio holdings include "forward looking statements" which may or may not be accurate over the long term. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate. These opinions are current as of the date of this report but are subject to change. Market values will vary so that an investor may experience a gain or a loss.

Davis Advisors' Large Cap Value Composite includes all actual, fee-paying, discretionary Large Cap Value investing style institutional accounts, mutual funds and wrap accounts under management for each investment period from April 1, 1969, through the date of this report, including those accounts no longer managed. Effective January 1, 1998, a minimum account size of \$3,500,000 was established. Accounts below this minimum are deemed not to be representative of the Composite's intended strategy and as such are not included in the Composite. A time-weighted internal rate of return formula is used to calculate performance for the accounts included in the Composite. For the net of advisory fees performance results, custodian fees are treated as cash withdrawals and advisory fees are treated as a reduction in market value. For mutual funds, the Composite uses the rate of return formula used by the open-end mutual funds calculated in accordance with the SEC guidelines adjusted to treat mutual fund expenses other than advisory fees as cash withdrawals; sales charges are not reflected. Wrap account returns are computed net of a 3% maximum wrap fee. For the gross performance results, custodian fees and advisory fees are treated as cash withdrawals. A list of Davis Advisors' Composites is available upon request.

Davis Advisors' Large Cap Value Composite Rolling 10 Year Performance. Davis Advisors' Large Cap Value Composite's 10 year average annual total return has beaten the S&P 500® Index for all rolling 10 year time periods since the first full calendar year after inception of the Composite (January 1, 1970) through December 31, 2009. The average annual total return earned by Davis Advisors' Large Cap Value Composite (net of advisory fees actually paid by clients, except for wrap accounts which are computed net of a 3% maximum wrap fee) was compared against the return earned by the S&P 500® Index for rolling 10 year time periods ending December 31 of each year. The Composite's returns assume an investment in the Composite on January 1 each year, with all dividends and capital gains reinvested for a 10 year period. The Composite's returns are presented net of advisory fees but do not include other expenses, such as custody or sales loads on mutual fund shares included in the Composite. If those other expenses were included, the reported figures would be lower. There can be no guarantee that Davis Advisors' Large Cap Value strategy will continue to deliver consistent investment performance. The performance presented includes periods of bear markets when performance was negative. Equity markets are volatile. An investor may experience a loss.

Clipper Fund's investment objective is long-term capital growth and capital preservation. There can be no assurance that the Fund will achieve its objective. Clipper Fund invests primarily in equity securities issued by large companies with market capitalizations of at least \$10 billion. Some important risks of an investment in the Fund are: market risk: the market value of shares of common stock can change rapidly and unpredictably; company risk: the market value of a common stock varies with the success or failure of the company issuing the stock; focused portfolio risk: concentrating a fund's portfolio in a select limited number of securities can increase the volatility of the portfolio; financial services risk: investing a significant portion of assets in the financial services sector may cause a fund to be more volatile as securities within the financial services sector are more prone to regulatory action in the financial services industry, more sensitive to interest rate fluctuations and are the target of increased competition; and foreign country risk: companies operating, incorporated or principally traded in foreign countries may have more fluctuation as foreign economies may not be as strong or diversified, foreign political systems may not be as stable and foreign financial reporting standards may not be as rigorous as they are in the United States. As of December 31, 2009, Clipper Fund had approximately 13.3% of assets invested in foreign companies. See the prospectus for a complete listing of the principal risks.

The **S&P 500® Index** is an unmanaged index of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The Index is adjusted for dividends, weighted towards stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. Investments cannot be made directly in an index.

Broker-dealers and other financial intermediaries may charge Davis Advisors substantial fees for selling its products and providing continuing support to clients and shareholders. For example, broker-dealers and other financial intermediaries may charge: sales commissions; distribution and service fees and record-keeping fees. In addition, payments or reimbursements may be requested for: marketing support concerning Davis Advisors' products; placement on a list of offered products; access to sales meetings, sales representatives and management representatives; and participation in conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events, and other dealer-sponsored events. Financial advisors should not consider Davis Advisors' payment(s) to a financial intermediary as a basis for recommending Davis Advisors.

After April 30, 2010, this material must be accompanied by a supplement that includes performance as of the most recent calendar quarter.

Shares of Clipper Fund are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested.